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Session 23PD
The Standard Nonforfeiture Law: Impact of Proposed Changes

Track: Product Development

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Summary: The NAIC is addressing broad changes to the Standard Nonforfeiture Laws (SNFL) through its General Nonforfeiture Project and is also considering interest-related changes to the SNFL for Individual Annuities in response to the low-interest-rate environment. Industry experts discuss possible changes and implications that could have an effect on product design and interest rate risk management Attendees learn of the various proposed changes and their possible impacts.

MR. NOEL JOHN ABKEMEIER: When we in the product development section put this program on the agenda seven months ago, at the time of the annual meeting last year, we looked at the two nonforfeiture developments. We saw that annuity nonforfeiture was churning around without a whole lot of momentum within the NAIC and its Life and Health Actuarial Task Force (LHATF), and it looked like it might drag out like most legal and regulatory changes, most model laws, do. So when we put this program together, we expected that we would have some kind of interim report on what might be coming out on the annuity nonforfeiture revision. Secondly, the general nonforfeiture revision, which has been kicking around for awhile in various ways in the NAIC, looked like it was moving into a period of some advancement, where there would be something significant to report as activity evolved on the NAIC side.

As events are, things are exactly the opposite. The annuity nonforfeiture revision did become a *fait accompli* in March, when the NAIC passed its model law and, therefore, things that we were calling proposed changes are real changes, and Eric will be talking about that. On the other hand, with the general nonforfeiture revisions, things have been a little bit in low gear, so there's less to talk about than

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we anticipated seven months ago. But I think there's a lot of insight into where things are heading that we'll be able to talk about.

In today's program, I will be the speaker on the general nonforfeiture revision. We'll cover that first. Eric will talk about the new annuity nonforfeiture model, and there should be ample time after that for questions and answers.

The concept for the general nonforfeiture revision has been around for a long time, even as we look at what's called the current era of revisions. It goes back to 1986, so it's been 17 years. It's been kicking around, but nothing has quite happened. I would like to look at the background that has brought us to where we are, the reasons we should have some changes, and ultimately look at what the possibilities are and what is taking place right now.

The current laws came from a much earlier era. The Standard Nonforfeiture Law for Life Insurance had its birth in 1942. Certain changes have taken place over the years. The Standard Nonforfeiture Law for Individual Deferred Annuities is 26 years old, so it, too, is from an earlier era, and much has happened since then. To keep these laws up-to-date, there have been some changes over the years or things outside of the law that try to handle other products, but the laws themselves still have tinges of an earlier era on them. Regulations and laws have been put in place, mainly regulations for variable annuities; universal life, 1984; modified guaranteed annuities, also known as market value adjusted annuities, 1985; variable life, a little bit later.

So steps have been taken to make things function, but still we've been living in an environment of "let's try to get things to fit into the old structure." The thought is that maybe it's time to have a new structure so we don't have to go through contorted approaches to achieve what we want. Also, I want to mention that life nonforfeiture did undergo a significant change in 1981, when dynamic interest was brought into the picture.

The laws do have formulaic approaches. There are product-specific requirements that really don't give the opportunity for flexibility from one company to another. There are certain floors that you must satisfy, and that tends to put a crimp on product development possibilities. The laws have the goal of preserving the insured's investment, and they always will. It is a consumer protection function that we're talking about. But with the laws as they exist, you have the requirement that you must have cash benefits in life insurance, and there's much thought of whether that really is a necessary component. Maybe you could do better if you didn't require cash benefits.

Within each of the laws, there's a certain smoothness test. In annuities, it's limiting the surrender charges. On life insurance, there's a different form of smoothness test. The laws are really focused on one line at a time. If you want to bridge from life insurance to annuity or vice versa, or bridge into other lines of insurance, such

as health insurance or casualty insurance, the laws really don't communicate, and that can be a bit constraining if you want to have certain kinds of more flexible design. Even within life insurance and annuities, it's a difficult transition to go from one to the other. You're really selling one policy and buying another. Why not have some potential of a flow from one into the other?

When we look at why we should spend time trying to change it, a lot of things have happened that suggest it's a good idea. Over the years there's been financial services deregulation. Once upon a time, life insurance, banks and brokerages had strong, clear walls between them. Each sold certain kinds of products. All of them were highly regulated. There wasn't any flow between them. But these walls have come down, and that has created more competition for the life insurers, more competition for the savings dollar. It suggests that perhaps things should be done to better position life insurance and annuities to compete with these other distribution systems.

Computer capabilities make everything possible. I find it very interesting that what took maybe as much as a week of work in 1967 is done in less than one second of computer work right now. It's just incredible what can be done. Whether it's modeling programs that are super-efficient or electronic spreadsheets, computer abilities have just made all the difference in the world and brought a lot of capability into what can be done. Because of that, you can price products that you had never thought of 20, 30 or 40 years ago. You can administer them and illustrate them with ease. But again, our nonforfeiture laws have not necessarily allowed us to proceed with all the products that we're capable of dealing with.

From the consumer perspective, needs have changed over the years. Family structures have changed. Preferences have changed. The availability of different products has caused people to understand their risk tolerances better and perhaps to desire products at different points on the scale of risk tolerance. People are perhaps better informed to be able to evaluate the difference between guarantees and possible benefits. We have seen on the investment side or on the brokerage side cash management accounts in which you have money market components, credit card components, insurance components, stocks, bonds, mutual funds—a full array of things. It can be of value to make sure that what we offer on the insurance side has the full degree of flexibility that we see in the products that are coming from our competitors.

In order to think of where we might go, there is value to look at what has been considered in the revisions of standards of general nonforfeiture, both life and annuity. The so-called "current phase" is viewed as starting 17 years ago. It's been a long discussion. We hope it's not too much longer, but one can never predict. Back in 1986, discussions began. In 1988, the Society of Actuaries Task Force on Nonforfeiture Principles became involved. As I look at things that evolved over the years, we'll see different themes coming forward. At this time, the theme coming through is removing restrictions on cash values. So it's been a long discussion of

whether there should be more freedom on cash values. But that seed has been planted, and it is being carried forward now. As we saw then, they looked at different alternatives, but the bottom line was that perhaps we don't need to have the strict cash value requirements.

In 1989, the American Academy of Actuaries set up a Task Force of Nonforfeiture Principles. At that time they again reinforced the idea that paid-up values are good, but maybe not the need to have cash values. At that time they were saying they still wanted to stick with the prospective methodology, but we may see that change in the future. They brought in the concept of economic adjustments to cash values, perhaps having some flexibility, as a possibility. Again, the recognition of nonguaranteed elements in general is being woven into the fabric.

In 1990, a working group of LHATF of the NAIC brought up new issues. The retrospective subgroup said that maybe we should have or allow a retrospective approach rather than the prospective approach that is embodied in the nonforfeiture law. Again touching on economic options, they said perhaps there should be more flexibility. In 1992, they started to look at different possibilities. Should it be only prospectively, or should we include retrospective concepts, moving us forward again to think about a different approach? But, unfortunately, there was no action.

In 1995, the LHATF working group again set down a set of principles, which I think is a good starting point for looking forward. Their premise for the principles is again providing a minimum standard and, importantly, not to discourage or unreasonably restrict product benefits or product designs. So they're looking forward, saying better product design would be a benefit to bring to the public. Another principle was to regulate at the least possible level, and it's good for regulators to have that perspective. It obviously is an industry perspective, but the regulators, too, were saying that we really should regulate at the lowest possible level.

Also, the principles include making sure that persisting policyholders aren't strongly advantaged or disadvantaged by departing policyholders. So it's maintaining an equity principle, although perhaps later on some concepts will change that a little bit. They do reinforce the idea that there must be paid-up benefits, but not necessarily a cash value, so insurers could provide benefits in kind rather than in cash. This is the first mention that there should be some consistency between annuity and life nonforfeiture, which could lay the groundwork for having some kind of blending of the two laws.

Finally, they got to the three-legged stool of consumer protection—that there should be some mandatory benefits, there should be some prohibited functions and there should be good disclosure of what you're doing. That three-legged stool can enable you to do many things with your products, while still serving the general public well.

Then in 1996, the most recent proposal on nonforfeiture revision was brought forward, and that's the so-called "plan" concept. Briefly, the "plan" concept is one in which the insurer will develop a plan to manage nonforfeiture values. The plan will say these are the rules of the game, how we're going to do it. They may be recognizing evolving experience, whether it's in mortality, investment, earnings or expenses, but they would have a plan that they would stick to, a very flexible approach. Such a plan would be filed and available to the regulatory authorities. The concept behind this was that insurers could develop a range of plans that could run from very high guarantees to the customer to very minimal guarantees, and a pact or an agreement would essentially be formed between the insurer and the customer. "Here's how we're going to do it, and here are the benefits you get." That would allow many flexible benefits to come forward.

This particular concept moved very far along in the discussions between the NAIC and the industry, although it ultimately stalled, I believe, because of concerns about whether the changes would make it difficult to maintain the tax-deferred status of life insurance under federal income tax law. At any rate, the "plan" concept brought in the idea that you would have nonguaranteed components that would be driven by an operational plan. The nonforfeiture benefits would have a very low floor, but you could have a plan that would make these flexible over time. Cash benefits would not necessarily be required. If an insurer wanted to offer them, they could, but they would not have to.

Within the plan is the nonforfeiture plan, which is really what you're communicating to the customer. The operational plan is what you're essentially communicating to the regulators. It shows how we will stand by our word on the nonforfeiture plan. Here there's a broadening of concept—not only life and annuity, but also health insurance was brought into the picture. The plan was based on a so-called fair deal between the insurer and the customer. You make a promise, and you deliver the promise. Management would attest to the regulators that they were standing by the laws and, secondly, that they were standing by their plan.

As it was proposed at that time, there would be a dual approach. Insurers could either, on a policy-form-by-policy-form approach, choose whether to use the new flexible approach or the existing program as we see it today. As I mentioned a moment ago, it did not pass. The industry did not really come to a unified position on accepting it, and, therefore, it died.

More recently, two years ago, the Academy had new discussions with LHATF on the topic, and it has become an issue that is on the table, of interest to pursue, but it does not yet have the full commitment to go full speed ahead. Last year one step was taken whereby the Academy did look at the concept of pursuing an approach that would rely on the certification of actuaries. We looked at how companies currently operate in relation to nonguaranteed elements and to dividend declarations, which involve actuarial certifications, and they seemed to work well. We used that as an extension to say the proper functioning in that area would seem

to lay a foundation for a nonforfeiture approach that also would rely on actuarial certification, such as in the "plan" approach.

More recently we have formed an Academy work group, which I head, that is identifying the product improvement benefits that could derive from nonforfeiture revision, the idea being to try to establish the case for why it is worth doing something now. At this time, we have a report in draft form that we will be completing in the next week and submitting to the NAIC in late June. We hope the report will prove the case for going forward at this time in pursuing general nonforfeiture revision to develop more flexible policies that would benefit consumers.

In relation to that, we have cited certain possible product improvements that we see. One of the leading ones is that a policy could start as life insurance and at an appropriate time chosen by a consumer, convert into an annuity, with no surrender, no new sale—just a smooth continuous flow from one to the other. It could further go into a long-term care benefit. We realize that there are existing products, life products with ancillary long-term care or even ancillary annuity-type benefits. But we're talking about the core product moving from one line to another and possibly to another. We feel that it would be beneficial to have that possibility within the laws.

Another one would be possibly a universal insurance. Right now, you have universal life insurance, but this would be an absolute universal insurance which would have one pot, one fund, out of which costs of insurance would be paid for many kinds of benefits—life insurance, health insurance, and even property-and casualty-type insurance could come out of it. Certainly zero-cash-value, permanent insurance, which we've seen successfully offered in Canada, is something that could be possible with revision, and we'd like to look at that closely. The plan-type approach that I described could again allow products all over the spectrum, which could give fair value to the customer in return for choosing the proper balance of guarantees and flexible benefits.

Market value adjusted life insurance is not recognized in the nonforfeiture laws. I understand a few states do recognize it. But generally it isn't on the radar screen, and it could be brought more into the mainstream with appropriate revisions. The revision in annuity nonforfeiture, which converted the nonforfeiture interest rate to an indexed basis, is a concept that could be brought over into the life insurance side. Another area is term insurance. There are constraints on when cash values must be offered on term insurance, and, consequently, level premium term insurance is not offered beyond certain ages. Or if you do have low-cost level term for a period, you may have very high guaranteed values later on as a contrived structure to justify low values. With revision you might be able to do directly what is achievable only indirectly right now.

We recognize that with changes in the nonforfeiture law, other systems are

impacted. Valuation systems differ between annuities and life insurance, namely, the Commissioner's Annuity Reserve Valuation Method (CARVM) versus Commissioner's Reserve Valuation Method (CRVM). Risk-based capital (RBC) requirements are different if you're getting outside of the life and annuity line and into some of the casualty business. You have conflicting requirements for similar events. Premium taxes differ from one kind of product to another, so if you're putting them together in one product, what taxes are you talking about? Perhaps the king of problems is federal income tax. Annuities and life insurance have different rules of the game for federal income tax treatment. If we're to merge into one product, we have to make sure that we address that kind of issue, too.
The point is that while a lot can be achieved through nonforfeiture revision, we recognize that other bases must be touched ahead of time. As a result, in our draft proposal from the Academy, we are conveying to the NAIC that we feel that this is the time to make changes. Perhaps the concept catchphrase might be to move into the 21st century in what we do on nonforfeiture. We probably will suggest that first there be a review of what other systems are affected, how we would deal with the required changes in other systems to be consistent with what is being done on nonforfeiture. So, we want to make sure that there is a clear path ahead.

Second, we would establish principles that would underlie any nonforfeiture revision and then finally go to work on it. So we're at the point where we're about to make a proposal along those lines. We hope that it will get a positive effort from the NAIC side and from the industry side, so that we might move into a general revision of nonforfeiture within the next couple of years. It's not tomorrow, but we think we're in a position to start taking the first steps toward it.

That is a picture of what might happen in that area. I'd like to turn it over now to Eric Carlson, who will tell you what has happened on the annuity nonforfeiture revision and explain some of the implications.

MR. ERIC J. CARLSON: This law went through at really record speed, and we believe it's well thought out and treats all appropriate aspects in the way they should be treated. However, I think some implementation questions may arise, and there will be a lot of uncertainty from company and state perspectives that will be worked out through regulation and Academy and NAIC work.

Today I'd like to just hit these four primary topics: what led to the need for a new law; what the new law looks like; administrative questions—we'll just start scratching the surface there; and then most important, what does the new law mean? Then I have a couple of real basic comparisons and non-numeric examples that look at the differences.

So, what led to the need for a new law? The short answer to that is declining interest rates. As rates continue to decline, companies face potential solvency risks. They really have two ways to work around this. There's an alternative solution that is allowed under the current law—or what I've deemed an alternative solution—and

then there's the temporary solution that was introduced in a lot of states.

If you think about it, how does a fixed annuity make any money? It's obviously based on its interest spread. As earned rates decline, the credited rate has to decline also, so the company can maintain that same spread. However, once the credited rate hits a floor, then you can start to run into trouble. Just to give you a little bit of background, the five-year Treasury note in May of 2000 was yielding 6.5%. In 2001 it was 4.9%. In 2002 it was 4.4% and last week, May 2003, it was yielding 2.4%. That is a phenomenal decline. For the past 40 years the maximum was just over 16%, in 1981, and its minimum is today, at 2.4%. The average over that time period—I'm not sure how relevant that may or may not be—is just over seven percent.

Companies, when they're working with their annuity contracts, really face two risks at a couple of different times. They face risk when they issue the policy. Is their earned rate greater than their credited rate, than the minimum credited rate, after recognizing the appropriate spreads? Then at times when they reinvest their assets, what is the earned rate at that future point in time compared to their required credited rate? Obviously the most immediate impact is really on their shorter-duration contracts. Short-duration contracts, of course, as we all learned when we talked about asset-liability management, require that you have short assets. Otherwise you'll have disintermediation risks. The shorter assets generally yield a lot less or somewhat less than long-term assets, and so the immediate impact really is on the short-duration contracts.

Companies that face the following issues really have to make decisions about their short-term contracts. Do they invest longer so they can keep their required spread and then face disintermediation risk? Do they pull the product since it's not profitable and exit the marketplace altogether? Or do they just lower their profit targets or subsidize that product line with another product line or even lock in losses? The risk also increases on long-duration contracts. It won't necessarily be of an immediate big risk, but it is definitely felt at reinvestment time for longer-duration contracts. There, it just gets right down to it—the inability to meet the three-percent guarantees and what happens with future rates.

If you had asked every single person in this room two years ago if rates could go any lower than they were, most people would have said no. Here we are two years later, and they are a lot lower. If we ask every single person in this room if rates can go any lower, I bet everybody will still say, there's no way. I have no idea. Maybe they will; maybe they won't.

There are really two possible explanations for the current environment. One is that we've entered a new era of low rates, and the other is that this is some type of a temporary aberration, and rates will pop back up to what they should be. If we're in a new era of low rates, then we have the issues we already talked about. We have product availability issues, solvency issues, maybe issues involving consumer

confidence in the marketplace if we run into some solvency problems. If it's an aberration and rates will pop back up, we face a different problem. When rates pop back up, people will surrender their contracts and reinvest at higher rates. Then we have a lot of surrenders when our assets are worth a lot less than the liabilities. The new law is written to address both of these situations by having an interest rate that fluctuates in the marketplace and also by giving the companies the ability to redetermine this interest rate at their reinvestment points or at future points in time. I'll hit both of those topics shortly.

Companies can address the low-interest-rate environment and their potential solvency risk in two different ways. One is allowed under the current law, and that is to lower credited rates to less than three percent, as long as the cumulative cash value meets or exceeds the minimum nonforfeiture value. For example, a company may define its account value as 90% of the first-year premium accumulated at two percent for 10 years and then after that point, it will accumulate at three percent. The policy form, however, must have been filed to reflect that. That certainly then becomes a more complicated product, both from the consumer and the filing and review process, and not all states will allow crediting rates less than three percent, nor will they allow necessarily a minimum guaranteed crediting rate that varies by duration.

The other solution is that in the last year or so, many states have passed a temporary law that reduces the nonforfeiture rate to 1.5% and holds all the other aspects of the law exactly the same. In fact, 32 states have either adopted or proposed this as of last week. States are continuing to pass this temporary solution today, and this generally sunsets within about two to three years after the effective date of the law. This certainly provides relief to companies; however, the companies have had to examine the costs and benefits of taking advantage of this. This relates to required product changes, filing changes, system changes, marketing and training for their staff and consistency of the products. If you have one version of the product that's available in many states and a different version of the same product available in a number of other states, that provides confusion for just about everybody.

So what does the new law look like? These are the topics we'll hit on: the forfeiture interest rate, equity-indexed annuity (EIA) considerations, the redetermination concept, retrospective test changes and then the six-month deferral change. The nonforfeiture interest rate, instead of being three percent, is now defined as a five-year constant maturity Treasury (CMT), rounded to the nearest five basis points. That must be based on the rates that existed within the last 15 months. It can be either a single date, a single point in time, or it could be an average of the five-year CMT, as long as all of the points in time on which an average is created are within 15 months of the issue date of the policy. You get a reduction from that five-year CMT of 125 basis points, with a floor of one percent and a cap of three percent. For example, if a five-year CMT is 2.5%, take off 1.25% and the minimum rate's 1.25%. If the five-year CMT is below 2.25%, you'll hit the floor of one percent; if

it's above 4.25%, you'll hit the cap of three percent.

There's special consideration for EIAs, and that's something that's new. They're not addressed separately at all in the old law. The need for it arises from the changes in the maximum loads that are allowed, and I'll hit that in just a second. When you start talking about the maximum loads, what you're getting at is the time at which a return of premium guarantee becomes effective for your EIA. The rationale for this consideration is that a company will provide both the guaranteed interest component and the guaranteed equity participation component.

Obviously that equity participation component may or may not result in increased credits to the policy. However, policyholders do have a guarantee of participation. For a product that provides "substantive" participation in an equity index, there is an additional offset of 100 basis points, so you get 225 basis points off the five-year CMT. It has the same floor and cap, one percent and three percent. Then there's language that says the market value of the equity guarantee must offset the additional 100 basis points reduction. Proof of that value, proof of the offset, must be provided to the commissioner, who may adopt rules or regulations to implement the EIA considerations. This is currently a very hot topic. There are discussions taking place each week to define exactly via regulation what all of this means and how it could all be demonstrated. Quite honestly, we could probably spend the rest of this session talking about nothing but EIAs. We won't do it, although I will come back to it a little at the end.

Redetermination is another new concept in this new law. That means the nonforfeiture rate may be redetermined periodically during the life of a policy. Whether a policy will include redetermination is optional for the insurer. The company picks if and at what point the redetermination will occur. The new law says that the redetermination date, basis and period shall be stated in the contract. The rationale behind this redetermination is that there is periodic reinvestment by the company, so to minimize the risk to the company, the nonforfeiture rate at any given point in time should generally be related to the interest-rate environment at that point in time.

For example, if you have a five-year CD-type annuity, a five-year surrender-type schedule, a company may choose to have a redetermination date five years from the issue date of the policy. That seems to make a fair amount of sense. One of the advantages of this is that it aligns the risk of the asset with the risk of the liability, and it provides additional flexibility in a nonforfeiture rate to the company. The balancing aspect to this is complexity and understandability of redetermination. If you think about it, you have to write this into your contracts, so how would you like to disclose and discuss five-year CMT, minus a spread, with your consumers or with your agents? Then also, how will you pick the new minimum rate? You need to determine that up-front—whether it will be a point in time on a certain date or if it will be an average over a period of time—and clearly define that.

There are changes to the retrospective test. The net considerations are now equal to 87.5% of the premiums paid versus the old law, which was 65% of first-year premiums and 87.5% of renewal premiums for flexible premium deferred annuities (FPDAs) and 90% of premiums for single premium deferred annuities (SPDAs). You are allowed to recognize a policy fee of $50 per year, even if no premiums are paid, versus the current $30 a year in which premiums are paid plus a collection charge of $1.25. Premium tax is deductible only if it's payable in the specific state, and the law clearly states that it's permitted only if it's paid by the company. If it is paid and subsequently credited back to the company, such as upon an early termination, the credit may not be taken. All of these cash flows in and out are accumulated at the same nonforfeiture rate of interest.

You will need to submit a written request and receive written approval from the commissioner to defer payments for up to six months. The request must address the necessity and equity to all policyholders of that deferral.

Some of the administrative questions we have include adoption by the states, the effective date, the speed of passage and the regulations and guidelines to support and clarify the law. As of mid-May, last week, 14 states had proposed or adopted the new law. I believe that included four that already adopted it and 10 that had proposed this. As I mentioned before, 32 states have proposed or adopted the 1.5% temporary law.

This model law was approved at the NAIC meeting in March 2003. Given this very late approval date, it's difficult for many states to introduce this law into their legislative sessions during 2003. Some states have adopted it. It's likely that we'll see a lot of adoptions over the next one to two years, depending on when the legislatures of each state are back in session. Once the law is effective, an existing policy form must comply with the new law within two years. Prior to that two-year period, a company may adopt a new law on a policy-form-by-policy-form basis. However, policy forms that are filed after the effective date of that law in a state will need to comply with the new laws. Companies almost certainly will have some forms approved under the old law and some forms approved under the new law. From a company perspective, changing the forms will depend on a variety of things: the company's priorities, the timing of its product introductions, company resources that are committed to this type of a project, their system limitations, et cetera.

One issue that I think has yet to be addressed in the filing process is that the guaranteed minimum interest rate will now need to be a variable. It's not a fixed rate of three percent or 1.5%. Many states generally don't like variable or bracketed text on guaranteed values. I'm unsure if this is going to cause any problems. Given that that's adopted in the model law, I wouldn't anticipate it, but these are the types of things that states and companies start to look at and that they've had to address.

There are two arguments concerning the speed of passage. It could be faster than the 1.5% law because it's an NAIC-approved model. It could be slower because it's a permanent solution and it's very complex. So the point I'm trying to make here is that I don't have any idea. I don't think anybody really does. A stated goal of the NAIC is for adoption to be uniform by all states. Uniformity is very important. As we've seen with the 1.5% law, with just over half the states having adopted it, some companies have not taken advantage of this. That may be for the same reasons we talked about before. You have product differences, system limitations and lack of uniformity across the country.

The law explicitly allows a regulation for clarification of the EIA considerations. As I mentioned earlier, there have already been several calls by a subcommittee of the Academy to attempt to clarify and resolve this issue. This is a very important topic to resolve because there have been a lot of questions by both state regulators and by individual companies on what this means and how we demonstrate this. There may also be other issues addressed by regulation.

We've covered a lot of changes and some administrative questions. What does it really mean? I think it means that interest crediting can be more responsive to the interest-rate environment. It's based on an index that is reasonably related to the assets that a company buys, and it also changes over time as companies face their different investment environments. There's greater solvency protection to the companies and, therefore, to consumers, which means the companies are more likely to be around to pay the benefits that they promised. It also means that there's more complete and diverse product availability to the consumer.

The interest crediting is another way of providing additional value to the consumer. Short-term guaranteed products can be offered at responsible and appropriate rates. The lower cost of the guarantee makes more excess interest available to provide benefits to the policyholder through equity participation, through ancillary benefits or other excess interest credits. The ability to reset the nonforfeiture rate provides a more realistic floor for products built around periodic reinvestment.

As for solvency protection, short-term guaranteed products can be offered responsibly rather than at a guaranteed loss. If you look at what has gone on in the marketplace, it's remarkable how many companies have continued to offer products when you can tell almost by definition that they are upside down on their interest spread. They are locking in a guaranteed loss, they're subsidizing it or they feel they can't afford to get out of that market segment.

Another issue is the three-percent crediting after the surrender charge period expires. That, I feel, doesn't make a lot of sense. This is a topic that really hasn't been that widely recognized or acknowledged. At the end of a surrender charge period, an annuity is essentially a demand or a money market type of a product. What this means, of course, is that the liability is much shorter. The company must, of course, invest a lot shorter. If you're investing short-term right now, you're

earning a very low rate—three percent. You're absolutely upside down at that point in time. This periodic redetermination and the index both help provide relief from that and help eliminate some of those risks.

Finally, a complete and diverse portfolio is available, including both short-term and long-term products. Consumer confidence that companies will be able to meet their obligations may be restored. The key concept here is that consumer demand for growth and protection products doesn't disappear just because the interest rate environment is low. So from a consumer perspective, continuing to have a full and complete product portfolio available to purchase is very important. Also, I think they very much recognize that interest rates are low. If they go out to buy CDs, they're getting a one-year CD rate of one percent. Consumers recognize that interest rates are low.

Now, I'll address some discussion items and go over a couple of examples. The first one is a very simple concept, the FPDA versus the SPDA. The previous distinction in the allowable premium loads is now removed, so it eliminates any incentives for a company to classify something as an FPDA when they think that it's primarily going to be sold as an SPDA. There will be no difference between the two products.

I'm trying to compare EIAs under the new law to non-EIAs under the new law to show where the offset factors in. You can probably figure this out pretty easily, but at a 2.25% five-year CMT, you subtract 125 basis points to determine the minimum rate for a non-EIA. That means you have a one-percent guarantee, which is the floor. The EIA can't go below that. So at that point there's no difference in the required credited rates between an EIA and a non-EIA. If you're between 2.25% and 3.25%, you have a proportional increase in the EIA offset that is less than 100 basis points. Between 3.25% and 4.25%, there is the full 100-basis-point offset, and then the offset grades down as the CMT increases up to 5.25%. Once you're above 5.25%, both of those annuities are at the three-percent cap, so there's no difference in the interest crediting rate between the two. So even though it seems that there's a large offset for EIAs, there's really only a full offset between 3.25% and 4.25% CMTs, and there's a partial offset beyond either end of this range.

I think it is very interesting to look at the relative benefits of EIAs under the new law compared to what they provide under the old law. I'll use an example of a typical old-version EIA product, which has a cash value equal to 75% of the premium accumulated at three percent. That means you have about a 10-year breakeven period until the consumer is guaranteed his return of premium. The new law has 87.5% of premium as the net amount. If you accumulate that at the floor of one percent, then EIAs are a little bit better off for an insurer relative to the old law because that produces a 14-year return of premium. But if you're at the three-percent guarantee, and if we're in a more normal interest-rate environment—if, in fact, higher rates are more normal—then you will have a five-year return of premium guarantee. That means that some of the values available to the company to go out and purchase call options are no longer there. They have to use up a

larger percentage of the assets in funding the interest-rate guarantees. You will see either lower participation rates or lower caps in those environments. That's really not to say that the change is good or the change is bad. It really just means that the relative benefits available for EIAs under the new law are different than they were under the old law.

Let's look a little bit at the minimum consumer value for the old law versus the new law. If you ignore everything other than the interest rate and the front-end load, under the old law 65% of first-year premiums was the net credit. You accumulate that at three percent. That results essentially in a return of premium at 15 years. Under the new law, if you have 87.5% of the premium accumulated at the lowest possible rate of one percent, that's a return of premium in 13 years. So under this scenario, the consumer is better off under the new law than he was under the old law.

Here is the overall summary of the changes we talked about recently. The relative value of different product structures will change, particularly EIAs. Consumers will sometimes have minimum values that are higher than the minimums allowed under the old law, and companies have both greater interest rate protection and solvency protection. So really, I think you should be able to view this as a win/win all around for companies, for consumers and for the industry as a whole. I think at this point I'll just open it up if anybody has questions specifically on the annuity law and then, depending on what type of questions there are, we can roll right into any other nonforfeiture questions.

MS. DIANE LLOYD: I have two questions actually about what you just went over, the part about individual deferred annuities. I believe it excludes variable annuities, however. The variable annuity model regulation, I believe, says that for the fixed accounts on a variable annuity, you would refer back to this law, and I'm wondering if that is the case in all states that have adopted these.

MR. CARLSON: It's my understanding that to date, there's been uniform adoption by the limited number of states. The NAIC is really pushing on that, so I think we'll see uniform adoption. But to get to your question, it's my understanding that this would affect the fixed account of a variable annuity the exact same way that it's regulated today. I'm not sure of the implications of that. I haven't thought through that very thoroughly yet, but I think there's definitely a lot of potential for confusion. You generally have no loads on a fixed account. That's a great point to bring up and think through.

MS. LLOYD: So it's really something you'd have to go through and look at each state's regulations to figure out?

MR. CARLSON: Again, I think the states would be fairly uniform. It's maybe more of an operational question. How can you administer it appropriately?

MR. ABKEMEIER: I guess I would say you should assume that it does apply to the general account of a variable annuity, and you may occasionally, ultimately, find a state that doesn't apply it.

MS. LLOYD: Part two of that question is: Have there been any recent changes to the way you would test for the variable portions of a variable annuity?

MR. CARLSON: Not that I'm aware of.

MS. LLOYD: All right. Most of the states do have stop-gap laws with a 1.5% rate and sunset provisions. When filing a new product with the state insurance department, to perform the nonforfeiture test—if we think that this is a product we will be selling beyond the sunset provision—I'm wondering how to go about demonstrating the test. Should I show two tests, one for issues up to the sunset date and one for issues beyond it? Do you have an opinion?

MR. CARLSON: I can jump in on that. That will be a little bit of a tricky issue, and I think the answer will vary dramatically state by state. From the states that I've talked to, you need to file the product and demonstrate the product under the current law. So for states that have the 1.5% as their current law you need to demonstrate at 1.5%. Whether or not they will allow you to submit an additional schedule page and demonstration or to do something additional so that you can convert over to the new law—if and when they pass that new law—is when it's going to start to vary quite a bit.

MS. LLOYD: All right. So potentially, you might have to refile at the end of the sunset?

MR. CARLSON: It would not surprise me if there are a lot of company filings over the next couple of years. Just to expand on that a little, the end of the sunset period may or may not actually be the determining date. It also could be that if we have a sunset date of 2005, they may adopt a new law before that.

MR. ABKEMEIER: After the end of the sunset period you may have other reasons to refile the policy, such as if you plan to use the redetermination for resetting of the nonforfeiture rate during the life of the contract. That's a contractual change that you will have to be filing anyway, so that may well be a driver of your redemonstration and refiling.

MS. LLOYD: Okay, thank you.

MR. JIM WAGNER: I'm with Foresters. I have a question about EIAs. Will the additional correspondence that will address EIAs address minimum participation and the mechanism of EIAs? Is that one of the considerations?

MR. CARLSON: That's a great question. There are conversations right now with an

Academy subcommittee that includes both some regulators and many industry people. They're discussing a paragraph in the new law that discusses when the equity index offset is available, how much additional offset is available, and what it needs to be. I'll read just a little bit of it. It says, "During the period or term that a contract provides substantive participation in an equity-indexed benefit, it may increase the reduction described in section B2 above by up to an additional 100 basis points to reflect the value of the equity-indexed benefit." That must be demonstrated to the commissioner and the demonstration appears to be defined as "the present value at the contract issue date and at each redetermination date thereafter of the additional reductions shall not exceed the market value of the benefit." That's about all the further we've gone right now. In the discussions that have occurred to date, there have been a lot of different opinions on what exactly that means. People are trying to debate and get a hard definition of each word and phrase in there so that it is widely understood and widely accepted. I know we'll get there, but it will be an entertaining ride.

MR. ABKEMEIER: But the thrust of it is clarifying how to demonstrate without putting in prohibitions and specificity. You refer to participation rates and so forth. The flow currently does not touch on that, but rather on how to demonstrate whatever it is that you do have.

MR. CARLSON: This is my opinion, but I would say that once the method of that demonstration is a little bit more defined, you would want to perform that demonstration on the basis of your guaranteed benefits—meaning your guaranteed participation rate and your guaranteed cap and so on—so that you can still vary your current rates according to market conditions at that time, knowing that as long as you meet or exceed what you've defined as your guarantees, that you'll still fall within approval of the demonstration.

MR. WAGNER: Okay, thank you. I guess I just asked the question because states have a varied approach to and current prohibitions on certain aspects based on minimum participation or the actual mechanism of indexation. I had one other question. Market value adjustments are not included. Is there a reason for that?

MR. ABKEMEIER: Do you mean they are not included in the revision or not included in the regulation that's evolving?

MR. CARLSON: It's addressed exactly the same as it is under the old law, which is to say that I don't think it's really addressed.

MR. ABKEMEIER: By the way, a regulation is in development now. Eric mentioned discussions at the Academy. It's not because the Academy group wanted to have the discussions. It's because the regulators want a regulation to clarify the equity index components, and there has been some discussion from one regulator as to whether to bring in market value adjustment clarifications in that regulation. It probably will not be in there, but it's not guaranteed not to be in there.

MR. DAVID HIPPEN: I'm from Florida, where we don't have a nonforfeiture law for individual deferred annuities, and it raises an interesting question. I've read recently that on deferred annuities, the general expectation is that one-percent or less of the folks who actually buy them will at some point turn them into annuities—in other words, start receiving a stream of payments based on some life contingency. In spite of not having a nonforfeiture law, it appears that most of the products, if not all, that are filed and in use in Florida seem to comply with what appears to be the standard nationally. I can't attest that that's solely because everybody just thinks that's a nice thing to do, but the low rate at which folks annuitize raises the question in my mind.

Certainly there is a rather large market for GICs in which there is no annuitization provision. There's something in the valuation law about how you set reserves for such things. I wonder whether there is or has been any consideration or concern over the possibility of banks and/or insurance companies issuing such products that look like deferred annuities—that either don't have an annuitization provision or that offer something like an Annuity 2000 mortality at 0.5% as the only life annuity option, clearly designed solely for deferral and later conversion at cash to something else. The one without any annuitization option would seem to not have any standard nonforfeiture law requirements because it wouldn't fit the definition of an annuity in any state that I know. I'm curious what the implications might be of such a product in the market and, with regard to nonforfeiture law and general actuarial ethics, with what ought to be nonforfeiture equity.

MR. ABKEMEIER: Are you talking about a product that would not be an insurance product per se?

MR. HIPPEN: By some definitions, GICs are not insurance but are permitted to be sold by insurance companies.

MR. CARLSON: I'm not sure there's a great answer to that question.

MR. HIPPEN: Less than one percent of the people are actually buying it as insurance. Why aren't banks selling the non-insurance version, which would ignore nonforfeiture and wouldn't even be filed with any state? I recognize there might not be an immediate great answer, but I think it poses something to think about.

FROM THE FLOOR: I guess I'd like to ask one about going to the life nonforfeiture. What is the thinking of the committee in terms of the whole federal income tax issue? That seems to be the issue on which the last proposal fell by the wayside. What is the strategy at this point? What is the thinking at this point on how to address the issue of tax deferral?

MR. ABKEMEIER: The phase that we're in is not problem-solving per se, but the strategy is to put that as a first issue. We want to address the issue of what strategy will be taken in relation to the tax issue and then other things like RBC and

other things I mentioned. But we want to put that first because on the previous go-around, that came in the last half of the ball game and dragged things down, so the issue is make sure that there is a workable approach on this. If there's not an approach, then let's not spin our wheels trying to go forward on it. But it's not an easy topic.

MR. CARLSON: Just to add to that, I think the goals right now are to state what could be done, what types of products could be created if the nonforfeiture law weren't a limiting factor. Then once we get that written up reasonably well and defined, another goal is to identify other limiting factors that would impact this. Then, as Noel said, we want to figure out how to work around it. The answer may be that there isn't a good reason to address these changes. It would depend on what happens at the first couple of steps.

MR. ABKEMEIER: Back on the tax issue per se, a question might be whether there is some way to get an advance revision or position from the IRS, almost an industry-wide private-letter ruling. It's not the right term, but to see if there is some way to have a dialogue with the IRS before stepping into the nonforfeiture revisions.

MR. GERALD ULLAND: I'm with Western & Southern Life Insurance Company. To the extent that contracts have been developed with the 1.5% minimum, I think there's the desire to use those contracts in states that are adopting this new law. One thought process is to potentially use those contracts until the Treasury reaches 2.75% and stays there for 12 to 15 months. Do you perceive problems from the state filing standpoint with that logic?

MR. CARLSON: I can't answer that for sure obviously. But clearly you'll have up until two years from the effective date in any particular state to continue selling that policy form without any problems. At the future point in time, depending on what your policy load is on the cash value, it may or may not be in compliance. If you are out of compliance, you would need to file. To the extent that 1.5% is acceptable under the new law and your policy loads are in compliance with the new law, it seems that you could make a case that there would be no need to refile because it's still in compliance with the law. However, I think you may find state-by-state variations on that.

FROM THE FLOOR: A few of the states have actually passed both regulations but you really can't file under the new one if it's not been passed yet.

MR. ABKEMEIER: The latest count is five states right now. Perhaps it's growing rapidly.

FROM THE FLOOR: And how many of those five are actually having a 1.5% law as well as the new one? New Mexico went straight to the new one; it never even had the 1.5%, so you can't file a form in every state that will be 1.5% initially and then

a new indexed rate.

MR. CARLSON: That's why there will be a lot of contract filing work, I think, over the next few years, both from the company perspective and the regulators' perspective. I think from conversations that I've had, a lot of states—if you have a policy form in which the only thing you're doing is changing the guaranteed values—may be willing to look at a minimal filing, really just a new demonstration, a new schedule page and the few things that have changed. They may not require you to refile everything.

FROM THE FLOOR: I just want to offer a little bit of information since we're in the process of doing that right now. We have called a number of the state insurance departments, and they will allow us to use our current policy forms with an endorsement that changes the minimum rate to 1.5%. So we plan to do a big blanket kind of filing. Some states are requiring additional spec pages or nonforfeiture demonstrations with the adjustment, but some of them are not. I don't know if anybody's getting ready to do any of that kind of work, but you have those options.

MR. CARLSON: That's a good suggestion.